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Stayzilla – what lies beneath the ecosystem

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Dispute raises questions on access to working capital for start-ups, prevailing sense of fairness

Even as the arrest of Yogendra Vasupal, founder of start-up firm Stayzilla, on charges of non-payment of dues to its vendor has seen the entire start-up ecosystem fuming, the demand for an environment that provides for a collateral-free working capital assistance of a specified limit is gaining increasing ground.

Such an assistance could be made available through the organised banking channels, said city-based investment banker S. Ramabadran. According to him, Stayzilla-like episode could have been avoided if the start-up had the access to working capital funding.

Observers feel that the happenings at Stayzilla also reflect the absence of a proper foundation for the start-up ecosystem to effectively address the ups and downs of business. The Stayzilla imbroglio, they point out, also underscores the need for educating the entire stake-holders in the start-up ecosystem - right from investors to entrepreneurs and vendors besides the law-enforcing authorities - on their rights and responsibilities.

In this instance, the arguments have been restricted only to whether it is a civil or criminal dispute. However, one needs to look at the larger picture - the issue of accountability, role of private equity players and the available mechanism to settle such disputes.

At one end of the dispute is a company which has raised $30 million from private investors and announced that it will shut down and revamp its business model. On the other is an unfunded media agency start-up Jigsaw, which is desperate to get back its dues.

While questioning the choice of law chosen in this instance, Aarthi Sivanandh, Partner, JSA, a legal firm, wonders if the investors could have bailed the start-up entrepreneur out of an ugly situation.

The episode in its wake has forced funded start-up fraternity to close ranks. Will this prompt more vendors to take criminal actions against failing start-ups? This fear must be seen in the context of a recent trend. According to data from start-up tracker Tracxn, 314 start-ups downed shutters in 2016. This year, the count is 5 so far.

According to Kartik Maheshwari of Nishith Desai Associates, a law firm, closing down operations or posting a blog entry will not help Stayzilla escape liability arising from its outstanding obligations. Under law, even if Stayzilla were to undergo voluntary winding up, it would have to first set off its liabilities towards its creditors, he says. A civil case to claim unpaid monies stretches for years before a final order is passed.

Given this, an increasingly large number of individuals are now choosing to file criminal cases alleging fraud, he says. "Irrespective of the veracity of the claims made by both the parties, technically there is nothing in the law that prevents a person from pursuing criminal action in cases where there is an alternative civil remedy available," he adds.

Experts aver that there are no quick-fix solutions in such disputes as the current legal process is cumbersome even though it allows for winding-up. The upcoming Insolvency and Bankruptcy Code could go a long way in addressing such situations.

"Parties could consider building in alternative dispute resolution mechanisms such as arbitration in their contracts as these are gaining popularity due to heavy backlog of cases in civil courts. Also, try to clear dues to the greatest extent possible – whether it is employee salaries, vendor payments or office rents. However, this may not solve the issue of intimidatory criminal filings," according to Sharanya Ranga, Partner, Advaya Legal.

Now most start-ups prefer having a structure of private limited companies or limited liability partnerships, when compared to proprietorship concerns as prevalent in the early 1990s, according to Nishit Dhruva, Managing Partner, MDP & Partners. The private limited company or limited liability partnerships structure helps promoters limit their liabilities.

Serial entrepreneur Chandu Nair points out that promoters should not forget their moral responsibilities towards settling liabilities, even if the company structure gives leeway. "There seems to be a culture of supporting and celebrating the funded start-ups when compared with the unfunded ones. Also, the war is between the new age versus traditional companies. A CIBIL-like system to measure credibility of the organisation as well as the founder should be explored," he adds.

According to Mr. Dhurva, Stayzilla is a prime example of a start-up malfunction and not meeting with its vendor obligations. "The funding structure of such start-ups entails tranche funding from venture capitalists (VCs) whereby the start-up broadcasts the funding figures even before the capital is received. However, with VCs placing pre-conditions to be met for such disbursements, the funding does not accrue in toto. This creates an uncertain environment in the start-up ecosystem which inflates the apparent creditworthiness of a start-up," he points out.

Prabhakar Mundkur, Chief Mentor, HGS Interactive Solutions, point out that media agencies offer wafer thin margins and non-payment from clients affects their reputation badly. “May more ad agencies be as tough with their clients. A long time time ago, political parties drowned a few Indian agencies by defaulting on media payments. Then the ad agencies took a stance with political parties: to accept business only on advance payments. The ad agencies should perhaps be doing the same with start-ups,” he adds.

A start-up ecosystem that practices fairness is what is needed at the moment.